

PROSPERITY BANCSHARES INC

Form 10-Q/A

October 28, 2005

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q/A**

Amendment No. 1

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(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2004**

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_**

COMMISSION FILE NUMBER: 000-25051

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**PROSPERITY BANCSHARES, INC.<sup>®</sup>**

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(Exact name of registrant as specified in its charter)

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**TEXAS**  
(State or other jurisdiction of  
incorporation or organization)

**74-2331986**  
(I.R.S. Employer  
Identification No.)

**Prosperity Bank Plaza**  
**4295 San Felipe**  
**Houston, Texas 77027**

(Address of principal executive offices, including zip code)

**(713) 693-9300**

(Registrant's telephone number, including area code)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

As of November 5, 2004, there were 22,379,953 shares of the registrant's Common Stock, par value \$1.00 per share, outstanding.

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**Explanatory Note**

The purpose of this Amendment No. 1 on Form 10-Q/A to the Quarterly Report on Form 10-Q of Prosperity Bancshares, Inc. (the Company) for the quarter ended September 30, 2004 (the Original Form 10-Q) is to restate the Company's interim consolidated financial statements as of and for the nine months ended September 30, 2004 and 2003 to correct amounts on the Company's consolidated statements of cash flows related to acquisitions as more fully discussed in Note 8 to the accompanying interim consolidated financial statements. Specifically, the amounts presented in the Company's consolidated statements of cash flows for the nine months ended September 30, 2004 in this Amendment No. 1 reflect a correction in the presentation of the Company's common stock issued in connection with acquisitions. This correction resulted in an increase in noncash activities. The Company also corrected certain other immaterial miscellaneous items in the consolidated statements of cash flows for the nine months ended September 30, 2004 and 2003. There was no change in the total increase in cash and cash equivalents. Further, these changes had no effect on the Company's consolidated statements of income, consolidated balance sheets or consolidated statements of shareholders' equity.

In addition, the Company has amended Item 4, Controls and Procedures, to update the disclosure regarding disclosure controls and procedures and internal control over financial reporting.

As a result of the restatement, the Company has determined it to be necessary to amend the Original Form 10-Q. This Amendment No. 1 amends and restates in its entirety Part I, Items 1 and 4 and Part II, Item 6 of the Original Form 10-Q. This Amendment No. 1 continues to reflect circumstances as of the date of the filing of the Original Form 10-Q and does not reflect events occurring after the filing of the Original Form 10-Q, or modify or update those disclosures in any way, except as required to reflect the effects of the restatement as described in Note 8 to the accompanying interim consolidated financial statements and to correct certain other immaterial miscellaneous items.

PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES

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**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1. INTERIM CONSOLIDATED FINANCIAL STATEMENTS****PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****(UNAUDITED)**

	September 30, 2004	December 31, 2003
	(Dollars in thousands, except par value and share data)	
<b>ASSETS</b>		
Cash and due from banks	\$ 60,874	\$ 71,983
Federal funds sold	71,995	11,730
	<u>132,869</u>	<u>83,713</u>
Total cash and cash equivalents	132,869	83,713
Interest-bearing deposits in financial institutions	600	262
Available for sale securities, at fair value (amortized cost of \$196,259 and \$260,533, respectively)	193,396	263,648
Held to maturity securities, at cost (fair value of \$1,165,039 and \$1,122,451, respectively)	1,160,182	1,113,232
Loans	1,007,420	770,053
Less allowance for credit losses	(12,861)	(10,345)
	<u>994,559</u>	<u>759,708</u>
Loans, net	994,559	759,708
Accrued interest receivable	10,140	10,119
Goodwill	150,585	118,012
Core deposit intangibles, net of accumulated amortization of \$2,231 and \$1,010, respectively	13,300	6,743
Bank premises and equipment, net	36,331	34,299
Other real estate owned	535	246
Other assets	20,817	10,505
	<u>\$ 2,713,314</u>	<u>\$ 2,400,487</u>
<b>TOTAL</b>	<b>\$ 2,713,314</b>	<b>\$ 2,400,487</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
<b>LIABILITIES:</b>		
Deposits:		
Noninterest-bearing	\$ 527,845	\$ 467,389
Interest-bearing	1,799,434	1,616,359
	<u>2,327,279</u>	<u>2,083,748</u>
Total deposits	2,327,279	2,083,748
Other borrowings	13,315	11,929
Securities sold under repurchase agreements	28,153	19,007
Accrued interest payable	2,717	2,522
Other liabilities	12,781	3,889
Junior subordinated debentures	59,804	59,804
	<u>\$ 2,444,049</u>	<u>\$ 2,201,209</u>

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Total liabilities	2,444,049	2,180,899
SHAREHOLDERS' EQUITY:		
Preferred stock, \$1 par value; 20,000,000 shares authorized; none issued or outstanding		
Common stock, \$1 par value; 50,000,000 shares authorized;		
22,415,541 and 20,966,706 shares issued at September 30, 2004 and December 31, 2003, respectively;		
22,378,453 and 20,929,618 shares outstanding at September 30, 2004 and December 31, 2003, respectively	22,416	20,967
Capital surplus	134,160	102,594
Retained earnings	115,157	94,610
Accumulated other comprehensive income (loss) net/unrealized (loss) gain on available for sale securities, net of tax benefit of \$1,002 and tax of \$1,090, respectively	(1,861)	2,024
Less treasury stock, at cost, 37,088 shares at September 30, 2004 and December 31, 2003, respectively	(607)	(607)
	<u>          </u>	<u>          </u>
Total shareholders' equity	269,265	219,588
	<u>          </u>	<u>          </u>
TOTAL	\$ 2,713,314	\$ 2,400,487
	<u>          </u>	<u>          </u>

See notes to interim consolidated financial statements.

**Table of Contents****PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME****(UNAUDITED)**

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
<b>(Dollars in thousands, except per share data)</b>				
<b>INTEREST INCOME:</b>				
Loans, including fees	\$ 14,760	\$ 11,675	\$ 39,222	\$ 34,630
<b>Securities:</b>				
Taxable	13,320	8,758	40,041	28,431
Nontaxable	359	395	1,115	1,228
70% nontaxable preferred dividends	183	452	825	1,327
Federal funds sold.	136	82	238	162
Deposits in financial institutions	5	3	7	14
<b>Total interest income.</b>	<b>28,763</b>	<b>21,365</b>	<b>81,448</b>	<b>65,792</b>
<b>INTEREST EXPENSE:</b>				
Deposits	6,316	5,459	17,783	17,074
Junior subordinated debentures	1,044	675	3,011	1,840
Federal funds sold and other borrowings	336	241	889	782
<b>Total interest expense</b>	<b>7,696</b>	<b>6,375</b>	<b>21,683</b>	<b>19,696</b>
<b>NET INTEREST INCOME</b>	<b>21,067</b>	<b>14,990</b>	<b>59,765</b>	<b>46,096</b>
<b>PROVISION FOR CREDIT LOSSES</b>	<b>420</b>	<b>120</b>	<b>660</b>	<b>360</b>
<b>NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES</b>	<b>20,647</b>	<b>14,870</b>	<b>59,105</b>	<b>45,736</b>
<b>NONINTEREST INCOME:</b>				
Customer service fees	5,237	3,523	14,827	10,148
Other	874	803	1,933	2,022
Gain on sale of securities			78	
<b>Total noninterest income</b>	<b>6,111</b>	<b>4,326</b>	<b>16,838</b>	<b>12,170</b>
<b>NONINTEREST EXPENSE:</b>				
Salaries and employee benefits	7,147	5,259	20,459	15,943
Net occupancy expense	1,499	1,045	4,055	2,988
Data processing	540	453	1,473	1,728
Core deposit intangible amortization	455	207	1,220	590
Depreciation expense	728	634	2,118	1,855
Other	2,825	2,109	8,395	6,461
<b>Total noninterest expense</b>	<b>13,194</b>	<b>9,707</b>	<b>37,720</b>	<b>29,565</b>

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INCOME BEFORE INCOME TAXES	13,564	9,489	38,223	28,341
PROVISION FOR INCOME TAXES	4,618	3,019	12,852	8,986
NET INCOME	\$ 8,946	\$ 6,470	\$ 25,371	\$ 19,355
EARNINGS PER SHARE				
Basic	\$ 0.41	\$ 0.34	\$ 1.19	\$ 1.02
Diluted	\$ 0.40	\$ 0.34	\$ 1.18	\$ 1.01

See notes to interim consolidated financial statements.

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**PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY**  
**(UNAUDITED)**

	<u>Common Stock</u>		<u>Accumulated</u>			<u>Treasury</u>	<u>Total</u>	
	<u>Shares</u>	<u>Amount</u>	<u>Capital</u>	<u>Retained</u>	<u>Other</u>			<u>Shareholders</u>
			<u>Surplus</u>	<u>Earnings</u>	<u>Comprehensive</u> <u>Income</u> <u>(Loss)</u>			
	(Amounts in thousands, except share data)							
BALANCE AT DECEMBER 31, 2002	18,903,028	\$ 18,903	\$ 60,312	\$ 72,917	\$ 2,644	\$ (37)	\$ 154,739	
Net income						26,548	26,548	
Net change in unrealized gain (loss) on available for sale securities.					(620)		(620)	
Total comprehensive income							25,928	
Exercise of stock options	170,638	171	824				995	
Refund of escrow shares in connection with the Paradigm acquisition						(570)	(570)	
Common stock issued in connection with the MainBancorp acquisition	1,499,966	1,500	33,149				34,649	
Common stock issued in connection with the FSBNT acquisition	393,074	393	8,538				8,931	
Stock option compensation			25				25	
Junior subordinated debentures issuance costs			(254)				(254)	
Cash dividends declared, \$0.25 per share				(4,855)			(4,855)	
BALANCE AT DECEMBER 31, 2003	20,966,706	20,967	102,594	94,610	2,024	(607)	219,588	
Net income						25,371	25,371	
Net change in unrealized gain (loss) on available for sale securities					(3,885)		(3,885)	
Total comprehensive income							21,486	
Exercise of stock options	203,644	204	808				1,012	
Stock option compensation			45				45	
Common stock issued in connection with the Liberty Bancshares acquisition	1,245,191	1,245	30,713				31,958	
Cash dividends declared, \$0.225 per share				(4,824)			(4,824)	
BALANCE AT SEPTEMBER 30, 2004	22,415,541	\$ 22,416	\$ 134,160	\$ 115,157	\$ (1,861)	\$ (607)	\$ 269,265	

See notes to interim consolidated financial statements.





**Table of Contents****PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****(UNAUDITED)**

	<b>Nine Months Ended September 30,</b>	
	<b>2004</b>	<b>2003</b>
	<b>(Dollars in thousands)</b>	
	<b>(As restated, see note 8)</b>	
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 25,371	\$ 19,355
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,338	2,445
Provision for credit losses	660	360
Net amortization of discount on investments	3,848	8,210
Loss (gain) on sale of other real estate	14	(22)
Gain on sale of premises and equipment	(321)	(244)
Stock option compensation expense	45	
(Increase) decrease in other assets and accrued interest receivable	(3,788)	(328)
Increase (decrease) in other liabilities and accrued interest payable	8,008	(4,707)
<b>Total adjustments</b>	<b>11,804</b>	<b>5,714</b>
<b>Net cash provided by operating activities</b>	<b>37,175</b>	<b>25,069</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Proceeds from maturities and principal paydowns of held to maturity securities	203,661	418,359
Purchase of held to maturity securities	(251,278)	(698,911)
Proceeds from maturities and principal paydowns of available for sale securities	73,304	108,782
Purchase of available for sale securities		(11,949)
Net (increase) decrease in loans	(39,611)	33,058
Purchase of bank premises and equipment	(901)	(3,119)
Net decrease in interest-bearing deposits in financial institutions	362	286
Proceeds from sale of bank premises, equipment, and other real estate	2,318	1,674
Purchase of Liberty Bancshares, Inc.	(9,132)	
Cash and cash equivalents acquired in the purchase of Liberty Bancshares, Inc	46,599	
Purchase of Village Bank & Trust ssb	(19,150)	
Cash and cash equivalents acquired in the purchase of Village Bank & Trust ssb	16,120	
Purchase of Dallas Bancshares, Inc.		(7,068)
Cash and cash equivalents acquired in the purchase of Dallas Bancshares, Inc.		10,517
Purchase of Abrams Centre Bancshares, Inc.		(16,865)
Cash and cash equivalents acquired in the purchase of Abrams Centre Bancshares, Inc.		38,458
<b>Net cash provided by (used in) investing activities</b>	<b>22,292</b>	<b>(126,778)</b>

*(Table continued on following page)*



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	Nine Months Ended September 30,	
	2004	2003
	(Dollars in thousands) (As restated see Note 8)	
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net (decrease) increase in noninterest-bearing deposits	(405)	86,975
Net (decrease) increase in interest-bearing deposits	(14,011)	52,800
Proceeds from the issuance of junior subordinated debentures		12,500
Junior subordinated debentures issuance costs		(129)
Net repayments of other borrowings	(1,230)	(24,202)
Net increase in securities sold under repurchase agreements	9,146	
Proceeds from exercise of stock options	1,012	372
Payments of cash dividends	(4,823)	(3,551)
<b>Net cash (used in) provided by financing activities</b>	<b>(10,311)</b>	<b>124,765</b>
<b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>\$ 49,156</b>	<b>\$ 23,056</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	<b>83,713</b>	<b>80,799</b>
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	<b>\$ 132,869</b>	<b>\$ 103,855</b>
<b>NONCASH ACTIVITIES:</b>		
Stock issued in connection with the Liberty Bancshares acquisition	\$ 31,958	

See notes to interim consolidated financial statements.

**Table of Contents****PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES****NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS****SEPTEMBER 30, 2004****(UNAUDITED)****1. BASIS OF PRESENTATION**

The interim consolidated financial statements include the accounts of Prosperity Bancshares, Inc. ®(the Company ) and its wholly-owned subsidiaries, Prosperity Bank ®(the Bank ) and Prosperity Holdings of Delaware, L.L.C. All significant inter-company transactions and balances have been eliminated. Prior period data has been restated to reflect the adoption of FIN 46R on January 1, 2004.

The accompanying unaudited interim consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, the statements reflect all adjustments necessary for a fair presentation of the financial position, results of operations and cash flows of the Company on a consolidated basis, and all such adjustments are of a normal recurring nature. These financial statements and the notes thereto should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2003. Operating results for the nine month period ended September 30, 2004 are not necessarily indicative of the results that may be expected for the year ending December 31, 2004.

**2. INCOME PER COMMON SHARE**

The following table illustrates the computation of basic and diluted earnings per share:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
	<b>(In Thousands Except Per Share Amounts)</b>			
Net income available to common shareholders	\$ 8,946	\$ 6,470	\$ 25,371	\$ 19,355
Weighted average common shares outstanding	21,843	18,974	21,250	18,948
Potential dilutive common shares	263	280	278	290
Weighted average common shares and equivalents outstanding	22,106	19,254	21,528	19,238
Basic earnings per common share	\$ 0.41	\$ 0.34	\$ 1.19	\$ 1.02

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Diluted earnings per common share	\$ 0.40	\$ 0.34	\$ 1.18	\$ 1.01
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The incremental shares for the assumed exercise of the outstanding options were determined by application of the treasury stock method. No options issued by the Company had an anti-dilutive effect for the three months September 30, 2004 and 2003 or for the nine months ended September 30, 2004 and 2003.

### 3. NEW ACCOUNTING STANDARDS

*FIN No. 46 Consolidation of Variable Interest Entities, an interpretation of Accounting Research Bulletin No. 51.* FIN 46 establishes accounting guidance for consolidation of variable interest entities (VIE) that function to support the activities of the primary beneficiary. The primary beneficiary of a VIE is the entity that absorbs a majority of the VIE's expected losses, receives a majority of the VIE's expected residual returns, or both, as a result of ownership, controlling interest, contractual relationship or other business relationship with a VIE. Prior to the implementation of FIN 46, VIEs were generally consolidated by an enterprise when the enterprise had a controlling financial interest through ownership of a majority of voting

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**PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES**

**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2004**

**(UNAUDITED)**

interest in the entity. The provisions of FIN 46 were effective immediately for all arrangements entered into after January 31, 2003, and are otherwise effective at the beginning of the first interim period beginning after December 15, 2003. The Company adopted FIN 46 on July 1, 2003.

In December 2003, the FASB issued FIN 46R, *Consolidation of Variable Interest Entities*. FIN 46R provides guidance on how to identify a variable interest entity and determine when the assets, liabilities, non-controlling interests and results of operations of a variable interest entity need to be included in a company's consolidated financial statements. A company that holds variable interest in an entity is required to consolidate the entity if the company's interest in the variable interest entity is such that the company will absorb a majority of the variable interest entity's expected losses and/or receive a majority of the entity's expected residual returns, if they occur. As of September 30, 2004, the Company had no investments in variable interest entities requiring consolidation. FIN 46R requires that Prosperity Capital Trust I, Prosperity Capital Trust II, Prosperity Statutory Trust III, Prosperity Statutory Trust IV and Paradigm Capital Trust II be deconsolidated from the consolidated financial statements. The Company adopted FIN 46R on January 1, 2004. After adoption, the trust preferred securities issued by each of the foregoing trusts are no longer shown in the consolidated financial statements. Instead, the junior subordinated debentures issued by the Company to each of these trusts are shown as liabilities in the consolidated balance sheets and interest expense associated with such junior subordinated debentures is shown in the consolidated statements of income.

In May 2004, the EITF reached a consensus on Issue 03-03 (EITF 03-03) *Applicability of EITF Abstracts, Topic No. D-79, Accounting for Retroactive Insurance Contracts Purchased by Entities Other Than Insurance Enterprises, to Claims-Made Insurance Policies*. This EITF clarifies that a claims-made insurance policy that provides coverage for specific known claims prior to the policy period contains a retroactive provision that should be accounted for accordingly; either separately, if practicable, or, if not practicable, the claims-made insurance policy should be accounted for entirely as a retroactive contract. The Company adopted the provisions of EITF No. 03-03 on January 1, 2004. The adoption of EITF 03-03 did not have a material impact on the Company's consolidated financial position, results of operations or cash flows.

In March 2004, the EITF reached consensus on Issue 03-01 (EITF 03-01), *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. EITF 03-01 includes new guidance for evaluating and recording impairment losses on debt and equity investments, as well as new disclosure requirements for investments that are deemed to be temporarily impaired. This Issue specifically addresses whether an investor has the ability and intent to hold an investment until recovery. In addition, Issue 03-01 contains disclosure requirements that provide useful information about impairments that have not been recognized as other-than-temporary for investments with in the scope of this Issue. On September 30, 2004, the Financial Accounting Standards Board deferred the effective date of the Issue's guidance on how to evaluate and recognize an impairment loss that is other-than-temporary. This Issue's guidance is pending the issuance of a final FASB Staff Position ( FSP ) relating to the draft FSP EITF Issue 03-01-a, *Implementation Guidance for the Application of Paragraph 16 of EITF Issue No. 03-01, The Meaning of Other-Than-Temporary Impairment and Its application to Certain Investments*, which the Board may issue as early as November. This deferral did not change the disclosure guidance which remains effective for fiscal years ending after December 15, 2003. Matters being considered by the FASB which may impact the Company's financial reporting include the accounting as a component in determining net income for declines in market value of debt securities which are due solely to changes in market interest rates and the effect of sales of available-for-sale securities which have market values below cost at the time of sale and whether such sale indicates an absence of intent and ability of the investor to hold to a forecasted recovery of the investment's value to its original cost.

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*SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity.* SFAS 150 establishes standards for how an issuer classifies, measures and discloses in its financial statements certain financial instruments with characteristics of both liabilities and equity. SFAS 150 requires that an issuer classify financial instruments that are within its scope as liabilities, in most circumstances. Such financial instruments include (i) financial instruments that are issued in the form of shares that are mandatorily redeemable; (ii) financial instruments that embody an obligation to repurchase the issuer's equity shares, or are indexed to such an obligation, and that require the issuer to settle the obligation by transferring assets; (iii) financial instruments that embody an obligation that the issuer may settle by issuing a variable number of its equity shares if, at inception, the monetary value of the obligation is predominantly based on a fixed amount, variations in something other than the fair value of the issuer's equity shares or variations inversely related to changes in the fair value of the issuer's equity shares; and (iv) certain freestanding financial instruments. The Company adopted SFAS 150 on January 1, 2004 and its adoption did not have a material impact on the Company's consolidated financial position, results of operations or cash flows.



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**PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES**

**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2004**

**(UNAUDITED)**

**4. RECENT DEVELOPMENTS**

On October 26, 2004, the Company announced the signing of a definitive agreement with FirstCapital Bankers, Inc. ( FirstCapital ), Corpus Christi, Texas. Under the terms of the agreement, FirstCapital will merge into the Company and subsequently, FirstCapital's wholly owned subsidiary, FirstCapital Bank, s.s.b. will merge into the Bank. The Company will issue approximately 5.0 million shares of its common stock for all of the issued and outstanding capital stock of FirstCapital.

FirstCapital is privately held and operates thirty-two (32) banking offices in and around Corpus Christi, Houston and Victoria, Texas. As of September 30, 2004, FirstCapital had, on a consolidated basis, total assets of \$773.6 million, loans of \$518.2 million, deposits of \$638.9 million and shareholders' equity of \$60.0 million. The acquisition is expected to close in the first quarter of 2005 and is subject to the approval of the Company and FirstCapital shareholders and customary regulatory approvals.

On August 1, 2004, the Company completed its acquisition of Village Bank and Trust, s.s.b. ( Village ), Austin, Texas. Under the terms of the agreement, the Company paid approximately \$19.1 million in cash for all of the issued and outstanding capital stock of Village. Village was privately held and operated one (1) banking office in the Lakeway area of Austin, Texas. As of June 30, 2004, Village had total assets of \$110.9 million, loans of \$79.7 million, deposits of \$97.3 million and shareholders' equity of \$10.4 million.

In connection with the purchase, the Company recorded a premium of \$12.2 million, of which \$1.0 million was identified as core deposit intangibles. The remaining \$11.2 million of the premium was recorded as goodwill. The core deposit intangibles are being amortized using an accelerated amortization method over an 8 year life.

The acquisition was accounted for using the purchase method of accounting. Accordingly, the assets and liabilities of the acquired branch were recorded at their fair values at the acquisition date.

On August 1, 2004, the Company completed its acquisition of Liberty Bancshares, Inc. ( Liberty ), Austin, Texas, pursuant to which Liberty merged into the Company and its wholly owned subsidiary, Liberty Bank, S.S.B., merged into the Bank. Under the terms of the agreement, the Company paid approximately \$9.1 million in cash and issued approximately 1.3 million shares of its Common Stock for all of the issued and outstanding capital stock of Liberty and Liberty Bank, and all outstanding stock options of Liberty Bank. Liberty was privately held and operated six (6) banking offices in Austin, Texas. As of June 30, 2004, Liberty had on a consolidated basis, total assets of \$178.7 million, loans of \$120.3 million, deposits of \$158.9 million and shareholders' equity of \$16.5 million.

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In connection with the purchase, the Company recorded a premium of \$27.6 million of which \$4.6 million was identified as core deposit intangibles. The remaining \$23.0 million of the premium was recorded as goodwill. The core deposit intangibles are being amortized using an accelerated amortization method over an 8 year life.

The acquisition was accounted for using the purchase method of accounting. Accordingly, the assets and liabilities of the acquired branches were recorded at their fair values at the acquisition date.

**Table of Contents****PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES****NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS****SEPTEMBER 30, 2004****(UNAUDITED)****5. GOODWILL AND CORE DEPOSIT INTANGIBLES**

Changes in the carrying amount of the Company's goodwill and core deposit intangibles (CDI) for nine months ended September 30, 2004 were as follows:

	<u>Goodwill</u>	<u>Core Deposit Intangibles</u>
	(Dollars in thousands)	
Balance as of December 31, 2003	\$ 118,012	\$ 6,743
Amortization		(1,220)
Acquisition of Liberty Bancshares, Inc.	22,914	4,636
Acquisition of Village Bank & Trust, ssb	11,114	1,040
Core deposit intangibles-First State Bank of North Texas	(1,801)	1,801
Expenses associated with the acquisition of First State Bank of North Texas	(239)	
Core deposit intangibles-MainBancorp	(300)	300
Expenses associated with the acquisition of MainBancorp	96	
Adjustments associated with the acquisition of Dallas Bancshares (deferred taxes)	(7)	
Adjustments associated with the acquisition of Southwest Bank Holding Company (deferred taxes)	796	
	<u>          </u>	<u>          </u>
Balance as of September 30, 2004	<u>\$ 150,585</u>	<u>\$ 13,300</u>

The Company initially records the total premium paid on acquisitions at management's best estimate of goodwill and CDI. Subsequent to the acquisition, a third party valuation of CDI is performed. Adjustments to CDI, if necessary, are appropriately reclassified within goodwill. Net income is decreased by the amortization of CDI which is amortized at an accelerated rate over an eight year period from the acquisition date. Adjustments to estimates of deferred taxes that relate to goodwill are made after reconciliations of the final tax returns are prepared. The reclassifications have no effect on total assets, liabilities, shareholder's equity or cash flows.

**6. NONPERFORMING ASSETS**

The Company had \$2.6 million in nonperforming assets at September 30, 2004 and \$967,000 in nonperforming assets at December 31, 2003, an increase of \$1.6 million or 165.0%. The increase in nonperforming assets is primarily due to two commercial loans, assumed from previous acquisitions, being placed on nonaccrual status and an additional two loans, assumed from acquisitions, being classified as accruing loans 90 or more days past due.



**Table of Contents****PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES****NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS****SEPTEMBER 30, 2004****(UNAUDITED)**

The following table presents information regarding nonperforming assets as of the dates indicated.

	September 30, 2004	December 31, 2003
	(Dollars in thousands)	
Nonaccrual loans	\$ 709	\$ 2
Restructured loans		
Accruing loans 90 or more days past due	1,238	679
<b>Total nonperforming loans</b>	<b>1,947</b>	<b>681</b>
Repossessed assets	81	40
Other real estate	535	246
<b>Total nonperforming assets</b>	<b>\$ 2,563</b>	<b>\$ 967</b>
<b>Non-performing assets to total loans and other real estate</b>	<b>0.25%</b>	<b>0.13%</b>

**7. SUBSEQUENT EVENT**

The Company has notified Wachovia Trust Company, trustee of Prosperity Capital Trust I (the Trust), that the Company intends to redeem on December 31, 2004 (the Redemption Date), subject to regulatory approval, the \$12.4 million in 9.60% Subordinated Debentures due 2029 issued by the Company to the Trust at a redemption price equal to \$12.4 million plus all accrued but unpaid interest up to the Redemption Date. In conjunction with the redemption of the Debentures, the Trust will notify the holders of its 9.60% Cumulative Trust Preferred Securities (Trust Preferred Securities) and its 9.60% Common Securities (Common Securities) of its intention to redeem on the Redemption Date all 1.2 million of its outstanding Trust Preferred Securities and all 38,000 of its outstanding Common Securities at a redemption price equal to the \$10.00 liquidation amount of each security plus all accrued but unpaid distributions up to the Redemption Date.

After redemption of the \$12.4 million in Subordinated Debentures issued to Prosperity Capital Trust I, the Company will have outstanding \$47.4 million in junior subordinated debentures issued to the Company's subsidiary trusts.

**8. RESTATEMENT OF INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

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Subsequent to the issuance of the Company's September 30, 2004 interim consolidated financial statements, the Company determined that amounts presented in the Company's consolidated statement of cash flows for the nine months ended September 30, 2004 reflected an error in the presentation of the Company's common stock issued in connection with acquisitions. This correction resulted in a \$32.0 million increase in non-cash activities. The Company also corrected certain other immaterial miscellaneous items in the consolidated statements of cash flows for the nine months ended September 30, 2004 and 2003. There was no change in the net increase in cash and cash equivalents. Further, these changes had no effect on the Company's consolidated statements of income, consolidated balance sheets or consolidated statements of shareholders' equity.

**Table of Contents****PROSPERITY BANCSHARES, INC. ® AND SUBSIDIARIES****NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS****SEPTEMBER 30, 2004****(UNAUDITED)**

The effect of the restatement on the Company's consolidated statement of cash flows for the nine months ended September 30, 2004 and 2003 is reflected in the table below:

Consolidated statement of cash flows:

	2004		2003	
	As Previously Reported	As Restated	As Previously Reported	As Restated
(Dollars in thousands)				
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>				
(Increase) decrease in other assets and accrued interest receivable	\$ (5,237)	\$ (3,788)	\$ 78	\$ (328)
Increase (decrease) in other liabilities and accrued interest payable	7,088	8,008	(4,569)	(4,707)
Stock option compensation expense		45		
Net cash provided by operating activities	34,761	37,175	25,613	25,069
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>				
Proceeds from sale of bank premises, equipment and other real estate	1,543	2,318	1,674	1,674
Premium paid for the purchase of Liberty Bancshares, Inc.	(22,914)			
Net liabilities acquired in the purchase of Liberty Bancshares, Inc. (net of acquired cash of \$46,599)	64,115			
Purchase of Liberty Bancshares, Inc.		(9,132)		
Cash and cash equivalents acquired in the purchase of Liberty Bancshares, Inc.		46,599		
Premium paid for the purchase of Village Bank & Trust ssb	(12,154)			
Net liabilities acquired in the purchase of Village Bank & Trust ssb (net of acquired cash of \$16,120)	8,579			
Purchase of Village Bank & Trust ssb		(19,150)		
Cash and cash equivalents acquired in the purchase of Village Bank & Trust ssb		16,120		
Premium paid for the purchase of Dallas Bancshares, Inc.			(2,982)	
Net liabilities acquired in the purchase of Dallas Bancshares, Inc. (net of acquired cash of \$10,517)			6,269	
Purchase of Dallas Bancshares, Inc.				(7,068)
Cash and cash equivalents acquired in the purchase of Dallas Bancshares, Inc.				10,517
Premium paid for the purchase of Abrams Centre Bancshares, Inc.			(6,992)	
Net liabilities acquired in the purchase of Abrams Centre Bancshares, Inc. (net of acquired cash of \$38,458)			28,203	
Purchase of Abrams Centre Bancshares, Inc.				(16,865)
Cash and cash equivalents acquired in the purchase of Abrams Centre Bancshares, Inc.				38,458
Total cash provided by (used in) investing activities	24,706	22,292	(127,322)	(126,778)
Net increase in cash and cash equivalents	\$ 49,156	\$ 49,156	\$ 23,056	\$ 23,056

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NONCASH ACTIVITIES:

Stock issued in connection with the Liberty Bancshares, Inc. acquisition.	\$	\$ 31,958	\$	\$
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ITEM 4. CONTROLS AND PROCEDURES

*Evaluation of Disclosure Controls and Procedures*

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in its SEC filings is recorded, processed, summarized and reported within the time period specified in the SEC's rules and forms, and that such information is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure based on the definition of disclosure controls and procedures in Rule 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply judgment in evaluating its controls and procedures.

Management, under the supervision and with the participation of the Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective. Subsequent to the date of that evaluation, management considered the restatement of the Company's interim consolidated financial statements and concluded that such restatement was the result of a material weakness related to controls over the preparation and review of its consolidated statement of cash flows. Based on such considerations, the Company's Chief Executive Officer and Chief Financial Officer concluded that as of September 30, 2004, the Company's disclosure controls and procedures were not effective solely because of the material weakness described below. Specifically, the Company did not maintain effective controls to appropriately classify the presentation of the Company's common stock issued in connection with acquisitions as a noncash activity rather than presenting it as a cash activity in the Company's consolidated statement of cash flows for the nine months ended September 30, 2004. This change in presentation resulted in an increase in noncash activities. The Company also corrected certain other immaterial miscellaneous items in the consolidated statements of cash flows for the nine months ended September 30, 2004 and 2003. There was no change in the net increase in cash and cash equivalents. Further, these changes had no effect on the Company's consolidated statements of income, consolidated balance sheets or consolidated statements of shareholders' equity.

*Changes in Internal Control Over Financial Reporting*

In an effort to remediate the material weakness in the Company's internal control over the preparation and review of its consolidated statements of cash flows described above, during the third quarter of 2005, management has implemented a process to aid in correctly classifying amounts related to acquisitions reflected in the consolidated statement of cash flows, including a more detailed cash flow statement preparation checklist. Accordingly, management believes this process will remediate the material weakness discussed above. There were no changes in the Company's internal controls over financial reporting during the third quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 6. EXHIBITS

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a. Exhibits:

### Exhibit

<b>Number</b>	<b>Description of Exhibit</b>
21.1**	Subsidiaries of Prosperity Bancshares, Inc.
31.1*	Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
31.2*	Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
32.1*	Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2*	Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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\* Filed herewith.

\*\* Previously filed.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

PROSPERITY BANCSHARES, INC. <sup>SM</sup>  
(Registrant)

Date: 10/28/05

/s/ David Zalman

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David Zalman  
Chief Executive Officer/President

Date: 10/28/05

/s/ David Hollaway

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David Hollaway  
Chief Financial Officer